OLR RESEARCH REPORT

May 31, 2012 2012-R-0201

OHIO'S COMMERCIAL ACTIVITY TAX

By: Rute Pinho, Associate Analyst

You asked for information on Ohio's commercial activity tax (CAT), specifically (1) what goods or services are subject to the tax, (2) who pays it, (3) how it has impacted Ohio's revenues, (4) its legislative history, (5) its effect on business activity in Ohio, and (6) how it compares to Connecticut's business taxes.

SUMMARY

Ohio's CAT is a tax on business gross receipts. Unlike a corporate income tax, which is imposed on a business' profits, a gross receipts tax is imposed on a business' total sales of goods and services, with no deduction for the cost of doing business. Ohio's CAT was designed as a broad-based, low rate tax that applies to most business types (e.g., retailers, service providers, and manufactures) and forms (e.g., sole proprietorships, partnerships, limited liability companies, and corporations). Businesses with "substantial nexus" with Ohio and at least $150,000 in taxable gross receipts in a calendar year must pay the tax. Taxable gross receipts include those from the sale of goods, performance of services, and rentals and leases.

The Ohio General Assembly established the CAT in 2005 as part of a series of tax reforms in the FY 06-07 budget (Am. Sub. HB 66). HB 66 phased-in the CAT and simultaneously phased-out the state corporate franchise tax and local tangible personal property tax for most

businesses. It directed revenue from the CAT to two funds to make payments to school districts and towns to mitigate the revenue loss from the repeal of the tangible personal property tax. HB 66 made many other changes to Ohio's tax structure, including (1) phasing in a 21% personal income tax reduction, (2) increasing the sales tax rate from 5% to 5.5%, and (3) increasing the cigarette tax from 55 cents to $1.25 per pack.

In FY 10, the first year in which the CAT was fully phased in, it generated $1.3 billion in revenue, less than half of the estimated revenue the state lost that year through the elimination of the tangible personal property tax and corporate franchise tax. CAT revenue increased to just under $1.5 billion in FY 11.

We located two studies that evaluated the fiscal and economic effects of the CAT and HB 66's other tax reforms, both of which note the difficultly in analyzing the effects of tax policy changes implemented during a significant economic recession. The most recent study (2011), performed by Ohio's Education Tax Policy Institute, concluded that HB 66 slightly reduced the overall progressivity of Ohio's tax system while simultaneously improving its (1) efficiency, (2) compliance, and (3) administration. But the study's authors maintain that one's view of the tax reforms' success "depends on one's view of the proper scale and scope of state government services."

The second study was conducted in 2009 by Policy Matters Ohio, an education and tax policy think tank that strongly opposed the CAT in 2005. Its authors suggested that economic indicators, including Ohio's poor employment record, stagnant economic output, and manufacturing job losses, are evidence that HB 66 contributed to the state's economic decline.

Connecticut does not impose a tax on business gross receipts comparable to Ohio's commercial activity tax. Rather, Connecticut levies a corporation business tax on C-corporations and a business entity tax on non-corporate business entities.

DESCRIPTION OF THE CAT

Tax Base

The CAT is levied on a business' taxable gross receipts sourced to Ohio. Taxable gross receipts are the amounts realized on transactions that contribute to gross income, without deduction for the cost of goods sold or other expenses incurred. They include gross receipts from the sale of goods, performance of services, and rentals or leases. Certain receipts are exempt from the CAT, including sales and use taxes collected by a vendor, interest, dividends, capital gains, wages reported on a W-2, and gifts.

Generally, gross receipts from the sale of tangible personal property are taxable only if the property is delivered to a location in the state. Receipts from services, on the other hand, are sourced to Ohio in proportion to the benefit the purchaser derives from them in the state.

Taxpayers

Any business entity that has (1) substantial nexus with Ohio and (2) at least $150,000 in taxable gross receipts in a calendar year is liable for the CAT. A business has substantial nexus if it has any one of the following in a calendar year:

1. at least $500,000 in taxable gross receipts;

2. at least $50,000 in property in Ohio;

3. at least $50,000 in payroll;

4. at least 25% of their total property, payroll, or gross receipts in Ohio; or

5. is domiciled in Ohio.

The tax applies to most business types (e.g., retailers, service providers, and manufactures) and forms (e.g., sole proprietorships, partnerships, limited liability companies, and corporations).

Major Exemptions

The following businesses and organizations are exempt from the CAT:

1. nonprofit organizations,

2. financial institutions,

3. insurance companies,

4. affiliates of financial institutions and insurance companies that pay the corporation franchise or insurance premiums tax,

5. dealers in intangibles (i.e., certain businesses engaged in lending money or buying and selling notes and securities), and

6. certain types of public utilities.

Rates

The CAT rate depends on a taxpayer's annual gross receipts. Taxpayers with annual taxable gross receipts of between $150,000 and $1 million must pay an annual minimum tax of $150. Taxpayers with annual taxable gross receipts over $1 million must pay $150 plus 0.26% of the taxable gross receipts over $1 million (with a $250,000 quarterly exclusion) (Ohio Department of Taxation, *Ohio's Taxes 2011: A Brief Summary of Major State & Local Taxes in Ohio*).

Phase-In

HB 66 phased in the CAT from 2005 through 2010 at the same time it phased out other taxes. Table 1 shows how this phase-in worked in relationship to the act's other major business tax reforms. HB 66 phased in the CAT by approximately one-fifth each year and phased out the corporation franchise tax for most businesses over that same period by one-fifth each year. It eliminated the tangible personal property tax on new manufacturing machinery and equipment (MME) beginning with the 2006 tax year. It phased out the property tax on all other tangible personal property (older MME, inventory, and furniture and fixtures) by lowering its assessment rate from 2006 through 2009.

Table 1: Phase-In of Business Tax Changes in HB 66

Tax Year	CAT Rate	Tangible Personal Property Assessment Rate			Corporation Franchise Tax**
		Inventory	MME	Furniture and Fixtures	
2005	0.06%	23%*	25%*	25%*	100% of tax liability
2006	0.06% (1/1 – 3/31) 0.1% (4/1 – 12/31)	18.75%	New MME – No tax Existing – 18.75%	18.75%	80% of tax liability
2007	0.1% (1/1 – 3/31) 0.16% (4/1 – 12/31)	12.5%	New MME – No tax Existing – 12.5%	12.5%	60% of tax liability
2008	0.16% (1/1 – 3/31) 0.21% (4/1 – 12/31)	6.25%	New MME – No tax Existing – 6.25%	6.25%	40% of tax liability
2009	0.21% (1/1 – 3/31) 0.26% (4/1 – 12/31)	No tax	No tax	No tax	20% of tax liability
2010	0.26%	No tax	No tax	No tax	No tax

*Same as 2004 rates

** Certain companies, such as financial institutions, continue to be subject to the full tax

Source: Ohio Department of Taxation, *Tax Law Rate Changes Under HB 66*

Revenues

Table 2 shows CAT revenue from FY 06 to FY 11. In FY 10, the first year in which the CAT was fully phased in, it generated $1.3 billion in revenue, less than half of the $3.26 billion Ohio's Office of Budget and Management (OMB) estimated was lost that year through the elimination of the tangible personal property tax and corporate franchise tax (*Executive Budget for FYs 2010 and 2011*). In FY 11, CAT revenues increased slightly to just under $1.5 billion.

Table 2: CAT Revenue FY 06 – 11

Fiscal Year	*Total Revenue (millions)*
06	$273.4
07	594.9
08	961.4
09	1,179.4
10*	1,342.1
11	1,451.6

*CAT fully phased-in for FY 10
Source: Ohio Department of Taxation, *Ohio's Taxes 2011: A Brief Summary of Major State & Local Taxes in Ohio*; OMB, *Executive Budget for FYs 2010 and 2011*

To mitigate the lost revenue from the repeal of the tangible personal property tax, HB 66 directed CAT revenues to two funds that provide payments to school districts and local governments. From FY 07 to FY 11, 70% of CAT revenue was directed to the state's School District Property Replacement Fund and the remaining 30% was directed to the Local Government Property Tax Replacement Fund.

Under HB 66, the amount of CAT revenue directed to the local government fund was scheduled to gradually decrease from FY 12 through FY 18, after which the revenue was redirected to the state's General Revenue Fund. HB 66 maintained the amount credited to the school district fund at 70%, but terminated the school district payments as of FY 19.

The FY 12-13 budget act modifies how CAT revenues are allocated, as shown in Table 3. In FY 12, 25% of CAT revenue will go into the state's General Revenue Fund and 52.5% and 22.5% will go into the school district and local government funds, respectively. Beginning in FY 13, 50% of CAT revenue will go to the General Revenue Fund and 35% and 15% will go into the school district and local government funds, respectively.

Table 3: CAT Revenue Allocation

Fiscal Year	*Prior Law (HB 66)*			*FY 12-13 Budget Act*		
	General Revenue Fund	*School District Fund*	*Local Gov. Fund*	*General Revenue Fund*	*School District Fund*	*Local Gov. Fund*
2012	5.3%	70%	24.7%	25%	52.5%	22.5%
2013 and thereafter	10.6%	70%	19.4%	50%	35%	15%

Source: Ohio Legislative Service Commission, Fiscal Analysis for Am. Sub. HB 153

LEGISLATIVE HISTORY OF OHIO'S CAT

The CAT and other tax reforms enacted in HB 66 were based in part on the recommendations of a 2003 legislative committee's study of Ohio's state and local tax structure. Among its recommendations, the committee proposed eliminating the state's tangible personal property tax and replacing it with a broad-based, low rate tax. The broad base would require a very low rate to raise the same amount of revenue as the existing tangible personal property tax and equalize the tax burden among manufacturers, which have relatively higher tangible personal property tax liabilities, and businesses that provide services. The committee recommended that the tax be based on either a business' (1) sales, property, and payroll or (2) gross receipts (*Report of the Committee to Study State and Local Taxes*, March 1, 2003).

In 2005, Ohio Governor Robert Taft II and legislative leaders made tax reform a priority in the FY 06-07 biennial budget. On January 18, 2005, Rep. Sally Conway Kilbane, a member of the 2003 study committee and chair of the House Ways and Means Committee, introduced HB 1 "to reform Ohio's tax code to improve economic competitiveness and foster job retention and creation, thereby making Ohio a more attractive place to live and do business." On February, 8, 2005, Governor Taft presented his biennial budget and proposed a tax reform package that would cut personal income tax rates and gradually eliminate the corporate franchise tax and the tangible personal property tax, replacing it instead with a new commercial activity tax on business receipts.

Proponents

One of the major proponents of the CAT was the Ohio Business Roundtable (OBR), an association of the chief executive officers of the state's largest businesses. In his testimony on HB 1 before the House Ways and Means Committee, OBR's Director Richard A. Stoff described the governor's and legislative leaders' tax reform plan as "a major step forward in modernizing the tax code and revitalizing Ohio's economy." Stoff contended that a gross receipts tax was a better alternative than the state's existing business taxes because it (1) applied uniformly to all businesses with gross receipts over $1 million and (2) was hard to avoid. Stoff remarked that the existing tangible personal property tax impacted business investment decisions by penalizing businesses that make capital investments with a higher tax burden. The proposed commercial activity tax, on the other hand, would create an incentive for new business investments (Hannah News Service, House Ways and Means Committee, February 23, 2005).

The Ohio Manufacturers Association supported the CAT because it would equalize the tax burden among the manufacturing and service sectors and thus lift the "anticompetitive burden on manufacturers" (Shockey, Alana. "Trade-Offs and the Waiting Game: Ohio's Commercial Activity Tax." *State Tax Notes*. June 30, 2008). The Ohio Society of CPAs also supported overall tax reform framework in HB 1 as "a positive first step towards providing a favorable climate for businesses and individuals to thrive" (Cathie Shaw and Kim Taylor. "Testimony before the House Ways and Means Committee," March 9, 2005).

Opponents

The Ohio Chamber of Commerce opposed the creation of the CAT, advocating instead for a single factor (sales) formula for the corporate income tax, combined with a business privilege tax. The chamber was concerned that the CAT would (1) automatically increase a company's tax liability for every dollar increase in sales and (2) adversely affect business-to-business sales, raising prices at all points along the supply chain.

Several businesses also opposed the tax, including the Dana Corporation and Ford Motor Company. Dana Co. expressed its concerns that the tax would be regressive since it applied to all companies regardless of whether they were profitable. Ford maintained that the tax would be applied each time a particular product changed hands.

The Ohio Petroleum Council and Ohio Petroleum Marketers & Convenience Stores Association also testified against the CAT because it would be imposed on each gasoline sale before the retail sale. The Ohio Council of Retail Merchants argued that the tax would disproportionately fall on retailers because the retail industry has lower profit margins than the manufacturing industry.

Policy Matters Ohio, a nonprofit, nonpartisan tax and economic development policy think tank, opposed the CAT on the grounds that it would not provide a stable and adequate long-term revenue stream for the state.

Other groups opposed the CAT on similar grounds, including the Ohio Grocers Association, Ohio Wholesale Marketers Association, and Ohio-Michigan Equipment Dealers Association (Sigritz, "Examining Ohio's Commercial Activity Tax," *State Tax Notes,* February 20, 2006; Shockey, Alana. "Trade-Offs and the Waiting Game: Ohio's Commercial Activity Tax." *State Tax Notes.* June 30, 2008).

Committee and Floor Action

On April 8, 2005, the tax reform package outlined in HB 1 and the governor's proposal was drafted and folded into amended substitute HB 66, the biennial budget. On April 12, 2005, the bill passed the House Finance and Appropriations Committee 21 to 10 and the House 54 to 45.

The Senate Finance and Financial Institutions Committee reported out a substitute version of the budget on June 1, 2005, by a vote of 9 to 4. The Senate passed the substitute bill 19 to 13 on June 2, 2005.

A conference committee was appointed to reconcile the House and Senate versions. The House approved the conference committee report by a vote of 53 to 46 and the Senate by a vote of 19 to 13.

CAT'S IMPACT ON BUSINESS ACTIVITY IN OHIO

2011 Education Tax Policy Institute (ETPI) Study

A 2011 study by Ohio's ETPI assessed the effects of the CAT and HB 66's other tax policy changes. But as the study points out, a number of factors make the assessment difficult. First, the act's major business tax reforms were simultaneously phased in between 2005 and 2010, making it difficult for researchers to isolate the impact of any one change. Second, because these policy changes were phased in during a significant economic recession, their performance "has likely been heavily impacted by macroeconomic events that were beyond the control of Ohio's tax administrators and policy makers." Third, lags in data releases made it difficult to fully evaluate the performance of HB 66 in 2011.

With these caveats in mind, the ETPI study concluded that HB 66 slightly reduced the overall progressivity of Ohio's tax system while simultaneously improving its (1) efficiency, (2) compliance, and (3) administration. But the study's authors remarked that one's view of the tax reforms "depends on one's view of the proper scale and scope of state government services." Specifically, the researchers note that:

> Those who favor efficiency, better compliance, simpler administration, and smaller state government may have a favorable impression of HB 66. Alternatively, those who would prefer a more progressive tax system that is better able to provide an enhanced revenue stream that is better able to keep up with economic growth might like to see additional changes.

2009 Policy Matters Ohio Study

A 2009 study conducted by Policy Matters Ohio, which strongly opposed the CAT in 2005, assessed HB 66's impacts on Ohio's economy and reported "unmistakable evidence that the state's relative economic decline accelerated since H.B. 66 was passed." But just as with the ETPI study, the Policy Matters study's authors noted that analyzing the policy changes is difficult because "Ohio's economic performance is strongly influenced by national and international trends and it is difficult to disentangle the effects of state policy from these factors."

The study reported that Ohio's:

1. employment record underperformed all surrounding states except Michigan in the three years following the tax reform;

2. real economic output stagnated from 2005 to 2007, just keeping pace with population growth;

3. inflation-adjusted personal income per capita realized a small 2.7% gain between 2005 and 2007, while national personal income grew by 4.8%; and

4. rate of manufacturing job loss over three years (3rd quarter of 2005 to 3rd quarter 2008) was 6.5%, compared to the national rate of 5.3%.

COMPARING OHIO'S CAT TO CONNECTICUT'S BUSINESS TAXES

Connecticut does not impose a tax on business gross receipts comparable to Ohio's commercial activity tax. Rather, Connecticut levies a corporation business tax on business profits. Connecticut's corporation business tax applies only to companies that are organized as C-corporations and that do business in the state. While Ohio levies a corporation franchise tax comparable to Connecticut's corporation business tax, it applies only to financial institutions and other specialized entities, such as financial holding companies and their affiliates, certain insurance company affiliates, and securitization companies.

Unlike Ohio, Connecticut levies a business entity tax on non-corporate business entities, known as pass-through entities, which include S corporations, limited liability companies, limited liability partnerships, and limited partnerships. In both Ohio and Connecticut, owners, shareholders, and partners of pass-through entities also pay personal income taxes on their share of the income the business generates.

Both Connecticut and Ohio exempt MME and business inventories from the property tax. But unlike Ohio, furniture and fixtures for business use in Connecticut are subject to the tax.

Table 4 compares these major business taxes in Connecticut and Ohio.

Table 4. Comparing Connecticut and Ohio's Business Taxes

Tax	*Connecticut*	*Ohio*
Commercial Activity Tax	No tax	Taxpayers with annual taxable gross receipts of: • $150,000 or less are exempt, • between $150,000 and $1 million are subject to minimum tax of $150, and • more than $1 million are subject to $150 tax plus 0.26% of taxable gross receipts over $1 million (with a $250,000 quarterly exclusion).
Corporation Income (Franchise)Tax	Tax rate is the greater of: 7.5% of net income, 3.1 mills per dollar of capital base, or $250 Financial services companies pay a tax equal to the greater of (1) 7.5% of net income and (2) $250 20% surcharge applies for 2012 and 2013 tax years	Financial institutions rate: • 13 mills (1.3%) on net value of stock apportioned to state Rate for other entities: • 5.1% of the first $50,000 of net income plus • 8.5% on net income over $50,000. Minimum tax: • $50 or • $1,000 if either (i) sum of gross receipts from activities inside and outside the state during taxable year is $5 million or more or (ii) total number of employees inside and outside the state at anytime during taxable year is 300 or more.

<table>
<tr><th colspan="2">Tax</th><th>Connecticut</th><th>Ohio</th></tr>
<tr><td colspan="2">Business Entity Tax</td><td>$250 per year (payable every other year starting with the 2013 tax year)

Applies to foreign and domestic LLCs, limited liability partnerships, limited partnerships, and S corporations</td><td>No tax</td></tr>
<tr><td colspan="2">Personal Income Tax</td><td>Rate range: 3% - 6.7%

6 brackets

Top marginal tax rate begins at:
• $250,000 for single/married filing separately
• $400,000 for head of household
• $500,000 for married filing jointly</td><td>Rate range: 0.587% - 5.925%

9 brackets

Top marginal tax rate begins at $204,201</td></tr>
<tr><td rowspan="3">Tangible Personal Property Tax</td><td>Business Inventories</td><td>Exempt</td><td>Exempt</td></tr>
<tr><td>MME</td><td>Exempt</td><td>Exempt</td></tr>
<tr><td>Business Furniture and Fixtures</td><td>Taxable</td><td>Exempt</td></tr>
</table>

Source: *Ohio's Taxes 2011: A Brief Summary of Major State & Local Taxes in Ohio*; CCH *State Tax Guide*

HYPERLINKS

126th Ohio General Assembly, HB 1, http://www.legislature.state.oh.us/bills.cfm?ID=126_HB_1, last visited May 25, 2012.

Education Tax Policy Institute's *Revenue Options for Ohio's Future*, http://www.etpi-ohio.org/assets/Ohio-Tax-Structure-ETPI-Report-May2011.pdf, last visited May 25, 2012.

Ohio Department of Taxation's *Tax Law Rate Changes Under HB 66,* http://tax.ohio.gov/channels/business/documents/tax_law_changes.pdf, last visited May 25, 2012.

Ohio Department of Taxation's *Ohio's Taxes 2011: A Brief Summary of Major State & Local Taxes in Ohio,* http://tax.ohio.gov/divisions/communications/publications/brief_summaries/new%20internet%20Feb_7_2012/2011%20Brief%20Summary_and_cover.pdf, last visited May 25, 2012.

Ohio General Assembly's *Report of the Committee to Study State and Local Taxes,* *http://tax.ohio.gov/channels/research/documents/CSSLT_Final_Draft.pdf*, last visited May 25, 2012.

Ohio Legislative Service Commission's *Final Fiscal Analysis for Amended Substitute HB 66,* http://www.legislature.state.oh.us/BillText126/FinalFiscalAnalysis.pdf, last visited May 25, 2012.

Ohio Legislative Service Commission's *Final Fiscal Analysis for Amended Substitute HB 153*, http://www.lsc.state.oh.us/analyses129/11-hb153-129.pdf, last visited May 25, 2012.

Ohio Office of Budget and Management's *FY 10 – 11 Executive Budget, http://obm.ohio.gov/SectionPages/Budget/FY1011/ExecutiveBudget.aspx*, last visited May 25, 2012.

Policy Matters Ohio's *The 2005 Overhaul and Ohio's Economy*, http://www.policymattersohio.org/wp-content/uploads/2011/10/TaxOverhaul2009_0115.pdf, last visited May 25, 2012.

RP:ro